MINUTES

MTC Income and Franchise Tax Subcommittee Teleconference
Tuesday, May 25, 2004
3:30 p.m. to 4:30 p.m. (Eastern)

Name	State or Affiliation
Kim Ferrell, Acting Chair	UT
Mike Brownell	CA FTB
Dick McFarlane	ID
Charla Wagner	KS
Louis Mandeville	ME
Keith Getschell	MN
Thomas Turnipseed	MS
Gene Walborn	MT
Jeff Sherman	OH
Paul Guthrie	OR
Janielle Lipscomb	OR
Eric Smith	OR
Amy Gill	PA
Donald Guyer	PA
Laurie Massengale	TX
MTC Staff and Consultants	
Frank Katz	
Rene Blocker	
Shirley Sicilian	

I. Welcome and Introductions – Kim welcomed everyone.

II. Public Comment Period None offered

III. Brief Tutorial on Intercompany Transactions – Mike Brownell, CA FTB

Hypothetical - Assume that Corps A and B are unitary and file combined report. A has a $60 asset that it sells to B for $100, showing a $60 basis and a $40 gain. The next year B sells the same asset to an outsider for $110 which it will show a basis of $100 and $10 gain.

Broadly there are three models for reporting the gain.

First, **current taxability**. - $40 gain by A from B taxed in year one, and $10 gain for B in year two

Second, **elimination and transfer**. A's separate-entity gain of $40 is eliminated and $60 basis is transferred to B. When the asset is sold by B in year two, B recognizes $50 gain to group.

Third, **deferral**. A's $40 gain taken into account, but deferred. B's sale to outsider shows two income events, A's $40 gain and B's $10 gain.

Deferral and elimination/transfer will generally have the same result if the parties don't disaffiliate

So change facts to show a disaffiliation. At end of year one, A and B disaffiliate. On elimination and transfer, when B sells in year two, the total gain is assigned to B's that gain is apportioned solely on B's apportionment factors. Under a deferral system, the $40 of gain is immediately taken into account under the acceleration rules and is apportioned using combined factors of A and B. This occurs even if B does not sell in that year. If B does sell in year two, B has a $10 gain, apportioned on its factors alone.

Arguments for and against each method:

- Current taxability – it is easy, doesn't have tracking issues. Problem is that it creates a major federal-state difference, a timing difference as federal is deferred. One would have to ferret out that sale also, as it wouldn't be reported to feds. Also current taxability is conceptually inconsistent with the unitary business treatment.

- Elimination and transfer – easy to write a rule for it. No complexity of methodology for restoration of income. But the argument against is the same that caused the feds to change to deferral. Elimination and transfer assigns income to the wrong entity. Gain attributable to Corp A is transferred to B. so that A got the money without any tax. Another problem is with disappearing income; all gain is inherent in asset basis. The basis in the property could become part of the basis in the stock, and when the stock is transferred, the basis in the stock could disappear under Sec 338 rules. Also there is concern about manipulation. Assume that Corp A has $60 asset and wants to sell to outsider for $110. It could form a subsidiary with $110 cash, so the basis in the stock of subsidiary is $110. A could then transfer the stock to B and under the elimination and transfer method there would be no recognition. B could then sell the stock to an outsider for $110 and have no gain. (The $50 gain is still lurking deferred, but the buying corporation could do the same thing when it sells.) The result can be a permanent deferral.

- Deferral – Argument for deferral is that it is much more likely to align with taxpayer's expectation because it matches the federal method and there is no difference between state and federal that has to be tracked, tracking that could potentially last for years. No need for separate fed/state tracking. Water's edge election can result in a deemed disaffiliation. Deferral cures problems of acceleration on disaffiliation. It avoids manipulation Argument against deferral is that it is more complex, uses different apportionment rules, and rules on what constitutes acceleration event. Conversion to nonbusiness use would be an acceleration event. Also if members are not in federal consolidated group, different rules for state purpose than feds. Large corporations will find this easiest, but medium and smaller corps will have a learning curve here.

The question for group is which model do it want to adopt?

IV. Committee Discussion on Policy Direction for Drafting Combined Reporting Rule.

Are there commerce clause prohibitions if asset is moved between states. Deferred system treats the entities as separate entities so no problem. But on elimination and transfer, there could be a due process issue if one state is taxing gain from activity in different state. But this is unlikely to be a problem. The deferral method has been in play for years and there has never been a commerce clause challenge.

California uses a deferred system whereby gain on the sale of an asset to sister company is deferred until asset is sold to outsider or disaffiliation. Timing could diverge from the federal determination if the companies become no longer unitary, but still remain affiliated. But that is rare.

Kim Ferrell noted that we are looking for the best rule here. Mike Brownell pointed out there will always be fed/state differences under any of the rules stemming from the different ownership thresholds and different constellation of companies in a combined report vs. a consolidated report. Since most states piggyback on federal returns, if no adjustments are made, states using a deferral system might not be aware of the sale of an asset unless the taxpayer chooses to make them aware.

No one supports current taxation metnod. Elimination and basis transfer did not draw any votes either. Kim moved to adopt the deferral method, Mike seconded it, and it was adopted without objection. This is not, Mike reminds us, a final decision but just drafting directions to Shirley.

Jeff Sherman asked whether the document would have a footnote recognizing the other alternatives not adopted. Shirley will be keeping a document that shows all our policy choices in drafting the proposal, but agrees that she can put the rejected options in a footnote for each policy decision.

Terminology note. Restoration and acceleration are the same and occur when the deferred income taken into account. They are triggered by a sale of the asset to an outsider or to a nonrelated unitary group, or an event occurs that ends the operation of the combined group as a single business, *i.e.*, disaffiliation, the group becomes non-unity, or the asset is converted to a nonbusiness use. Kim moved this definition of a restoration/acceleration event, Mike seconded and it was adopted unanimously.

Using the apportionment percentage at time the acceleration event occurs is consistent with federal practice and conceptual use of the division analogy and sourcing at the time of the acceleration event. It is also easier to use the current factors and not have to trace back in time for some earlier factors. Using current apportionment factors approach ws adopted by committee.

With regard to IRC §301(c)(3)) the committee deferred consideration until next meeting.

Carry over item from last teleconference with respect to charitable deductions. Shirley's notes show that the committee may need more time to think about and we would bring it back in CT for July meeting.

Next conference call on partnerships is on June 30th. FTB is drafting regulations on partnerships, but they may not be ready to share for a while until they reach the formal hearing level. The committee will deal with the two other deferred items then, also. Shirley will be working on draft for end of June.

VII. Adjourn at 4:40